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Washington Revisits Financial Regulation

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The credit-market turmoil has sparked a broad rethinking of how Washington regulates financial institutions, giving momentum to several ideas once thought politically unfeasible.

One central issue: What to do with the Federal Reserve, which is taking on more responsibility for the stability of financial markets. Last week, the central bank set a precedent by agreeing to lend funds to investment banks.

Crises often have led to big changes in Washington regulation. The Great Depression spawned the Federal Deposit Insurance Corp. The savings-and-loan crisis of the late 1980s produced the Office of Thrift Supervision, the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board.

In a speech, House Financial Services Committee Chairman Rep. Barney Frank (D., Mass.) said Thursday that policy makers should consider giving a regulator the authority to monitor risks that threaten the broad financial system.

Rep. Frank said this power could be given to the Fed, and he said the entity would supervise risks across all financial markets "regardless of corporate form." Such an idea would more closely align supervision of big Wall Street investment banks and their huge commercial-bank counterparts, which operate under different regulatory frameworks.

"You have two different types of institutions competing with each other but under different rules," Rep. Frank said in an interview. "It's the function, not the form, that's important."

While such a change would threaten the turf of some Washington regulators, officials at the Treasury Department already have been considering a similar restructuring.

Senior Treasury Department officials have spent months drawing up a blueprint for financial-market regulation that also includes a new vision for the central bank's role. The Treasury plan, which has been submitted to the White House for review, could propose moving the Fed out of day-to-day supervision of state-chartered banks, people familiar with it said. Instead, the Fed would be given a more sweeping responsibility to monitor financial-market stability.

Such a change would need congressional approval. A Fed spokesman declined to comment.

"The fundamental question of how to appropriately regulate financial-services companies is incredibly important," Assistant Treasury Secretary David Nason said in an interview. But he said the issue "becomes harder and harder as the financial system grows and becomes more complex."

The Fed has traditionally supervised commercial banks in part to safeguard the money it lends to them. Now it lends to investment banks but has no formal oversight, prompting calls to expand its role. "We're going to lend to them and protect them, shouldn't they be regulated?" former Federal Reserve Chairman Paul Volcker said on the "Charlie Rose" show Tuesday.

At least eight federal agencies supervise different segments of the financial markets. Some agencies have overlapping authority, such as the Fed and the Office of the Comptroller of the Currency, which both regulate parts of the banking industry. Other pockets are left mostly unregulated, such as mortgage brokers and hedge funds.

"I think there is a role to reform and modernize, but I think we have to be cautious not to overreact," said Rep. Vito Fossella (R., N.Y.).

Securities and Exchange Commission Chairman Christopher Cox called the regulatory structure "stove piping that dates back many decades and is nearly irrelevant to today's market." He said he welcomes Congress taking up an overhaul.

Under federal law, the SEC, which was created during the Depression, is charged with protecting investors and maintaining fair and orderly markets. Its role is in contrast with the Fed, which, through its oversight of bank-holding companies, is focused on maintaining the safety and soundness of financial markets and the banking system.

The unraveling of Bear Stearns Cos., one of the firms under the SEC's consolidated review, exposed limits to what the SEC can do. Unlike the Fed, it can't inject funds into the system or extend loans to brokerage firms. After Bear reached a deal to be sold to J.P. Morgan Chase & Co., the SEC issued a statement saying customer accounts were protected and Bear met its capital requirements.